NATIONAL RATING AGENCY

NRA Banking report 2Q 2016

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1. Key Developments and Facts

- *In June 2016, the Central Bank of Russia (CBR) cut its key interest rate to 10.5 percent p.a.*

By reducing its key rate by 0.5 percent the regulator gave rather a positive message to the market, reflecting its optimistic outlook for the economic stabilization and the fact that the inflation rate is getting lower in line with the CBR scenario. The consumer price inflation is rising at a rate lower than the key rate, but a number of factors, such as the continued inflation deceleration, oil prices and the currency risk, are adding to CBR's cautious stance. However, the regulator may decide to cut its key rate further, if the inflation and the associated risks continue to go down.

- *CBR tightened its provisioning requirements (PRs) in respect of the banks' ruble- and FX-denominated liabilities*

In June, CBR raised its PRs twice – by 1 percentage point (p.p.) in respect of FX-denominated liabilities and by 0.75 p.p. in respect of the banks' other liabilities subject to provisioning. In the regulator's opinion, this measure should "step up the banks' demand for liquidity in August-September, putting down CBR's need to hold the weekly forex deposit auctions in autumn and allow for the banking sector's smoother transition to the surplus liquidity position, still expected in early 2017".

- *the base rate of member banks' contributions to the compulsory deposit insurance fund was raised to 0.12 from 0.1 percent*

This rate will come into effect in 3Q 2016. The increase is due to the DIA's desire to speed up the inflow of funds needed, among other things, for the repayment of CBR's loans.

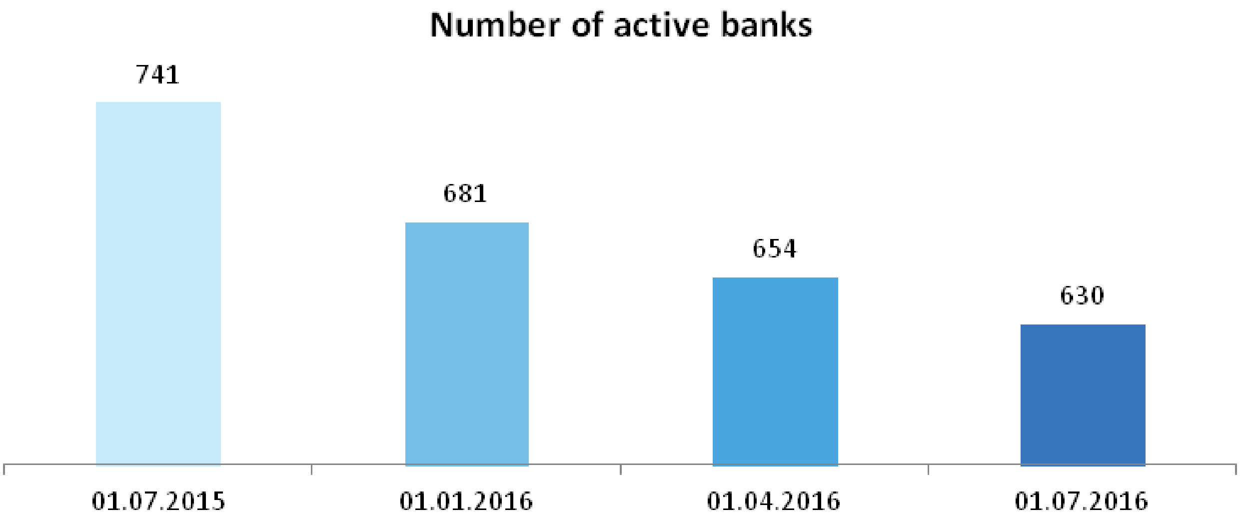
- *adoption of changes to the banks' financial rehabilitation system has been announced*

CBR intends to become more involved in the banks' rehabilitation by not only making financial injections, but also taking control (previously administered through the DIA) over the rehabilitation procedure. In addition, it is proposed to set up a special fund to receive the capital of banks under rehabilitation.

2. Market Participants

Out of 654 Russian banks active at 1 Apr 2016, 25 were deprived of their licenses in April-June 2016. None of the banks deprived of its license was systemically important.

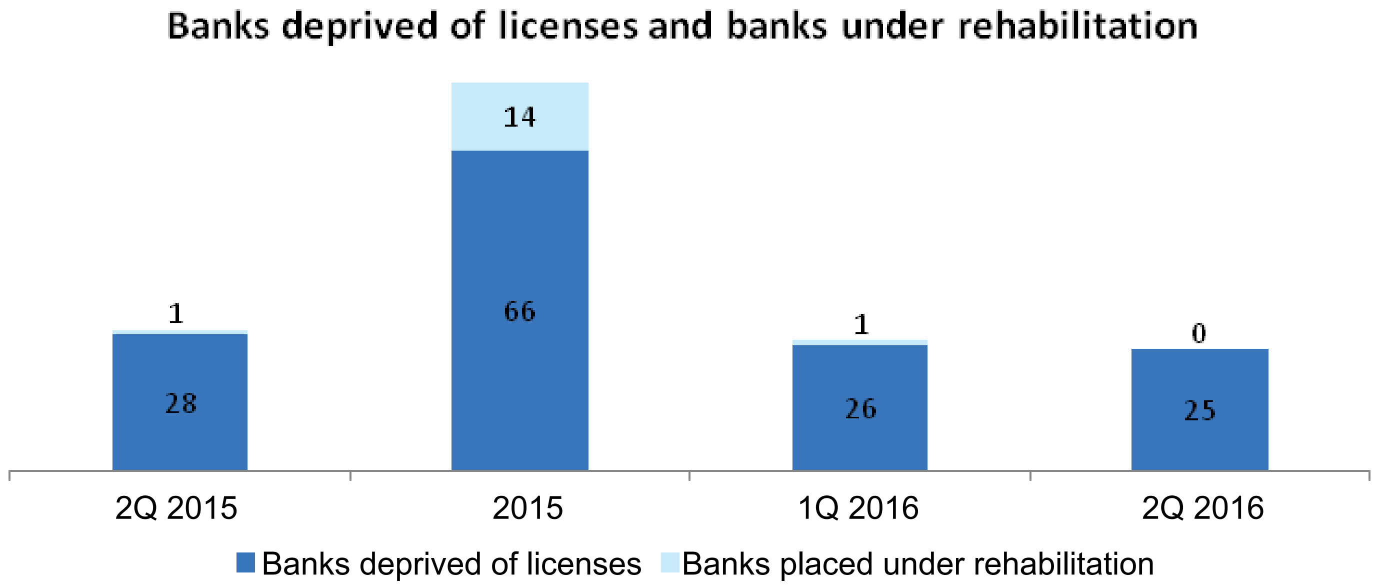
No banks were placed under rehabilitation. However, Finance and Industry Bank (Russian: *Финансово-Промышленный Банк*; Reg. No 2157) has submitted to CBR its own financial rehabilitation plan to consider and is waiting for the regulator’s decision. At the end of 1H 2016, there were 630 active banks in Russia.



CBR’s data

“As before, the license withdrawals were mainly due to exposure to risky asset classes, inadequate risk assessment or provisioning practices reducing the N1 capital adequacy ratio to critical levels and putting banks into a negative equity situation”.

In its media releases announcing the withdrawal of banking licenses, CBR highlighted risky lending policies in 16 cases and the N1 ratio reduction below 2 percent in eight cases.



CBR's and DIA's data

In April 2016, the rate of member banks' contributions to the deposit insurance fund was raised to 0.12 from 0.1 percent. Given the expenditures of the Deposit Insurance Agency (DIA) and the amount the DIA owes to CBR, one can expect further increases of the contribution rate. The rising cost of deposits for banks, associated with the higher contribution rate, may lead to a new small reduction of retail deposit interest rates.

The regulator apparently is not quite satisfied with the banks' financial rehabilitation and the fact that the process is under the DIA control, as it proposes changes to the rehabilitation procedure. For instance, CBR's Instruction No 4010-U 'On the Procedure For Holding Non-Public Tenders For the Selection Of Entities Acquiring Banks' Property And Liabilities' has been put in place to tighten the requirements for banks claiming or undertaking the roles of those in charge of rehabilitation. In addition, CBR intends to take control over the rehabilitation process and set up a special fund to receive the capital of banks under rehabilitation. The financial rehabilitation procedures put in place earlier will remain under the DIA's control.

3. Banking Sector's Financial Performance and Concentration

Russian banks active at 1 June 2016, held total net assets of RUB 77.4 trillion (NRA's estimate, not including banks that do not disclose their financials publicly), down 2.5 percent since the beginning of 2Q2016 and down 4.2 percent since the beginning of the year. The figure is 6.7 percent higher than a year earlier.

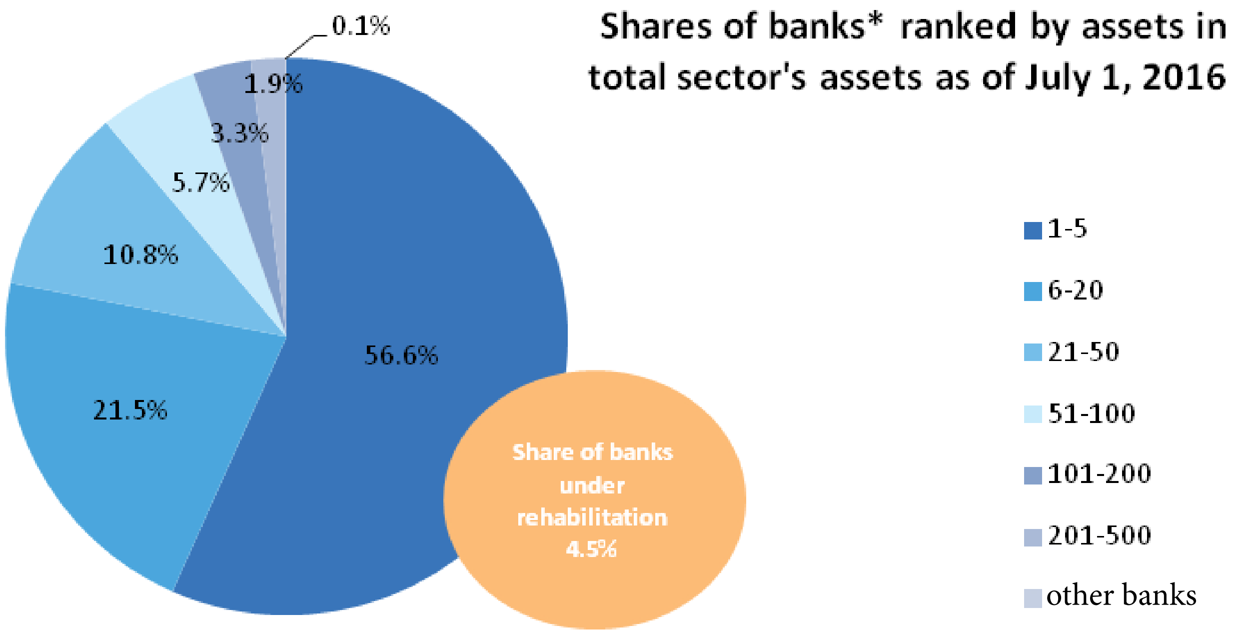
As the number of small and medium-sized banks is decreasing, banks under rehabilitation find themselves merged with entities in charge of rehabilitation, and the "flight to quality" (in which bank customers move their deposits away from riskier to the safest possible

banks) continues, the concentration in the banking industry becomes more pronounced, with the largest banks controlling a great part of all assets in the Russian banking sector.

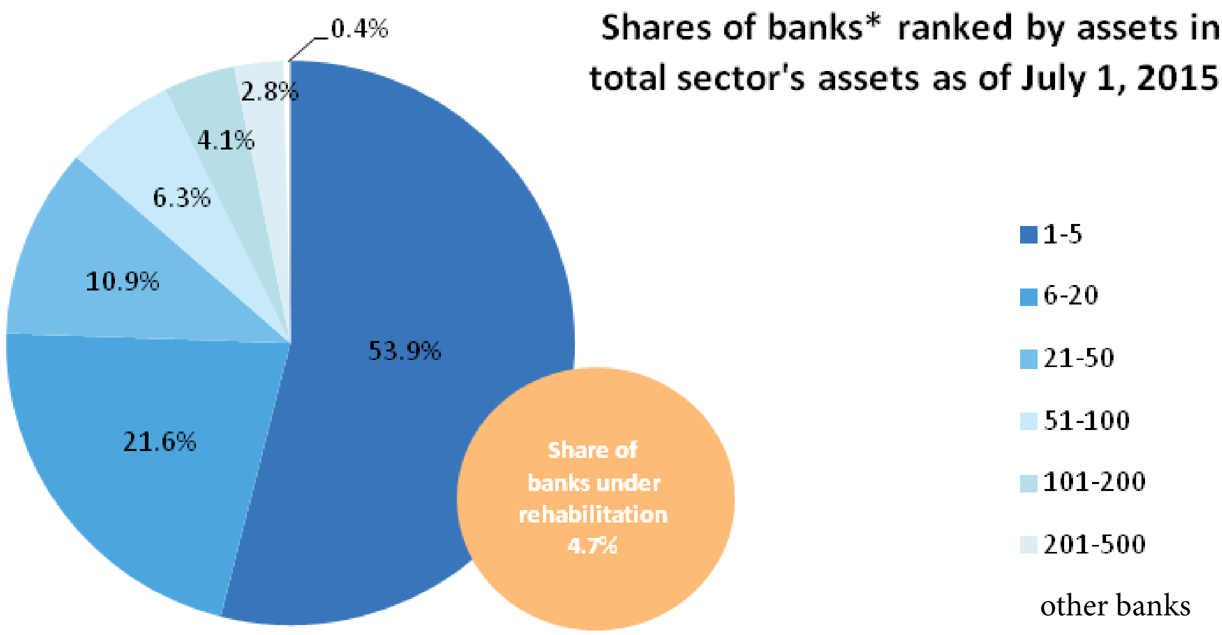
"The share of five largest banks in the total banking assets increased to 56.6 from 55.5 percent in 2Q 2016, while the share of the top 200 banks remained the same at 97.7 percent (vs. 96.8 percent a year earlier)".

In addition, the top 200 banks now account for 98.4 percent of the sector's total loan portfolio, and 98.1 percent of total retail and corporate deposits.

The share of smaller banks, beyond the top 500, decreased to 0.1 percent by the end of 2Q 2016 from nearly 0.4 percent at 1 July 2015.



* NRA's estimates, not including banks that do not disclose their financials publicly



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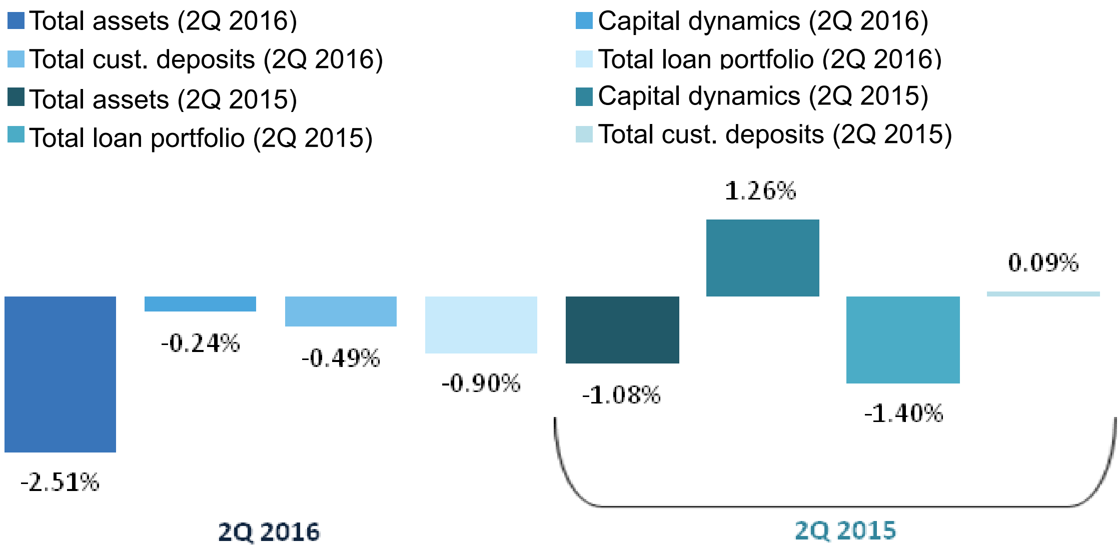
The banking industry's performance metrics in 2Q 2016 do not compare well with those for 2Q 2015. The only favourable development was a lower decrease in customer deposits in 2Q 2016.



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The negative dynamics of key performance indicators in 1H 2016 and 2Q 2016 was not very high and indicated a correction and stagnation rather than meaningful changes. Meanwhile, total assets of the banking sector increased by 6.7 percent, total loans by 5.6. percent, liability to customers by 12.4 percent, and total equity by 9.7 percent in the course of 12 months.

“Last quarter, the Russian banks earned more on the total than in 1Q 2016 and more than in the 2nd quarter (and 1st half of) 2015”.

The sector’s net income in 2Q 2016 increased to RUB 250.6 bn (RUB 359.9 bn for 1H 2016) from RUB 109.3 bn in in 1Q 2016. vs just RUB 6 bn). As usual, Sberbank accounted for a great part of this (RUB 229.4 bn in 1H 2016 and RUB 129.0 bn in 2H 2016). The banks’ loan-loss reserves (LLR) continue to weigh heavily on their profitability metrics. The banks’ LLR outlays, minus re-established reserves, totaled RUB 405.8 bn at 1 Jul 2016, according to CBR.

“The sector’s total loan portfolio was still on a downward trend (a 2.1 percent decrease in 1Q 2016 and a 0.9 percent decrease in 2Q 2016), with total retail loans unchanged and gaining a 0.3 larger share (24.4 percent) of the total loan portfolio in 2Q 2016”.

The situation was marginally better on the deposit taking front, with customer deposits down 0.5 percent to RUB 48.8 trillion in 2Q 2016. An increase in retail term deposits in 2Q 2016 was not enough to offset the customer deposits’ general negative dynamics.

4. Corporate and Retail Lending

The growth of nonperforming loans (NPLs) was somewhat lower than a year earlier, but the presence of NPLs in the loan portfolio and the associated LLR outlays continue to impact the lending activity of the Russian banks.

Total amount of loans issued in 2Q 2016 decreased 0.9 percent to RUB 44.9 trillion. The decrease was less pronounced than in 1Q 2016 and 1Q 2015 (minus 2.1 and minus 1.4 percent respectively). The total loan book increased 5.6 percent in the course of 12 months. The retail and corporate loans in 2Q 2016, at RUB 10.9 trillion and RUB 32.5 trillion respectively, had both fallen at a lower rate (minus 0.01 and minus 1.1 percent respectively) than in 1Q 2015.

The NPL trends were even better.

“The sector’s total NPLs growth in 2Q 2016 was 0.65 percent in 2Q2016 (vs. 14.2 percent in 2Q 2015). NPLs increase for both retail and corporate loan books was less than 1 percent in 2Q 2016”.

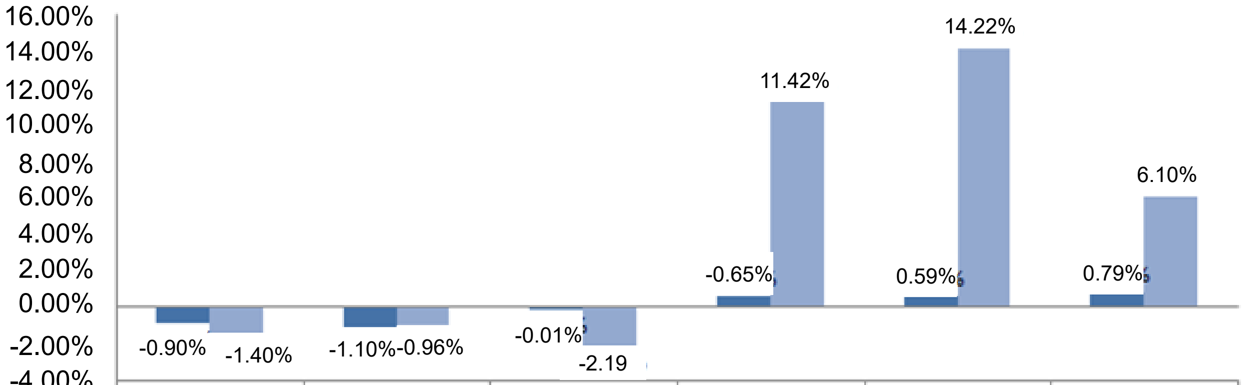
However, the proportion of NPLs in the sector’s total loan book is on a rise due to a number of factors, including the lending contraction. At 1 July 2016, NPLs totaled RUB 3.2 trillion, or around 7.2 percent of total issued loans.

The banks tightened their underwriting standards as far back as 2015, but in the

current economic environment, there are less high-quality borrowers than in 2012-2014 among companies with access to bank loans.

Retail lending is slowly adapting to the changes and getting closer to norm, but this would have hardly been possible without the mortgage and auto loan subsidizing, provided by the state.

Total bank loan and NPL growth in 2Q 2015 and 2Q 2016



	Total loans	Private corporate loans	Retail loans	Total NPLs	Corporate NPLs	Retail NPLs
2Q 2016	-0.90%	-1.10%	-0.01%	-0.65%	0.59%	0.79%
2Q 2015	-1.40%	-0.96%	-2.19%	11.42%	14.22%	6.10%

** NRA's estimates, not including banks that do not disclose their financials publicly*

"The sector's total loan portfolio was still on a downward trend (a 2.1 percent decrease in 1Q 2016 and a 0.9 percent decrease in 2Q 2016), with total retail loans unchanged and gaining a 0.3 larger share (24.4 percent) of the total loan portfolio in 2Q 2016".

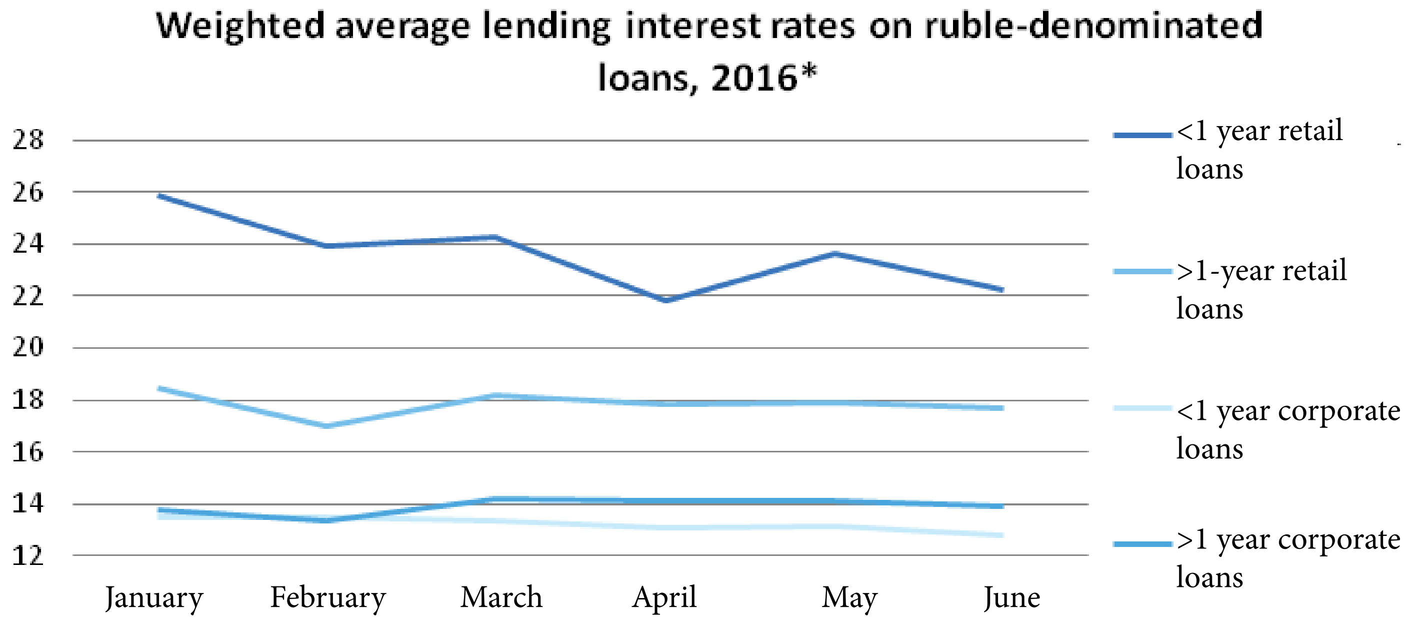
Over the six months ended 30 June 2016, the Russian banks' total mortgage portfolio increased 4.7 percent (to RUB 4.2trillion), while the amount of FX-denominated loans decreased 28.8 percent (to RUB 96.4 bn).

The FX-denominated-loans-to-total-mortgage-loans ratio decreased to 2.8 from 3.3 percent during the same period, while the level of NPLs grew by 7.8 percent to RUB 77.3 bn. It is noteworthy that in 1H 2016, the NPLs growth was driven by NPLs in the ruble loan portfolio ((+14.6 percent since the beginning of the year) rather than the FX loan portfolio s (-3.1 percent). But for a longer time period (12 months ended 1 July 2016) the growth of NPLs in the ruble- and FX-denominated loan portfolios was comparable (37.1 and 34.8 percent respectively).

The amount of issued loans and average loan size in 2Q 2016 were larger than a year earlier

(204,300 and RUB 1.68million vs. 149,100 and RUB 1.66million respectively), although the average loan size was larger in 1Q 2016 (RUB 1.71 million).

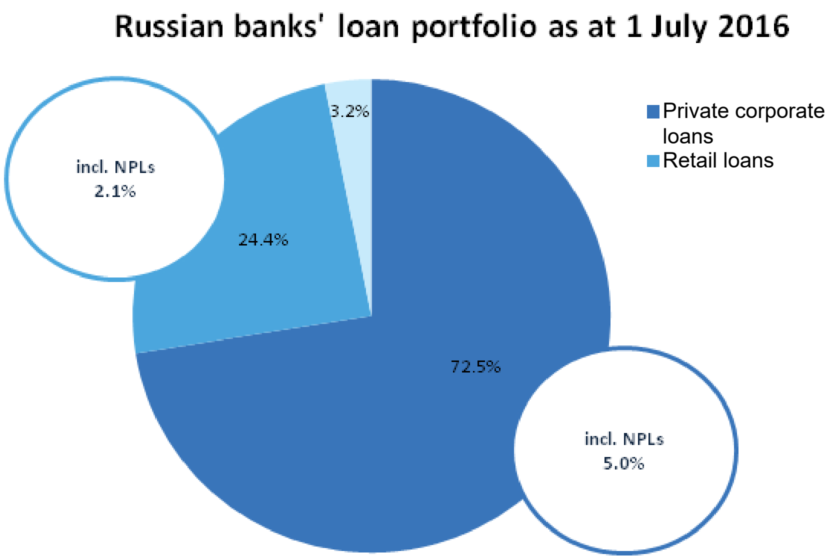
Moscow, Moscow Oblast and St Petersburg are leaders among the Russian regions by mortgage lending volumes, according to CBR.



* CBR's data (excluding Sberbank's interest rates)

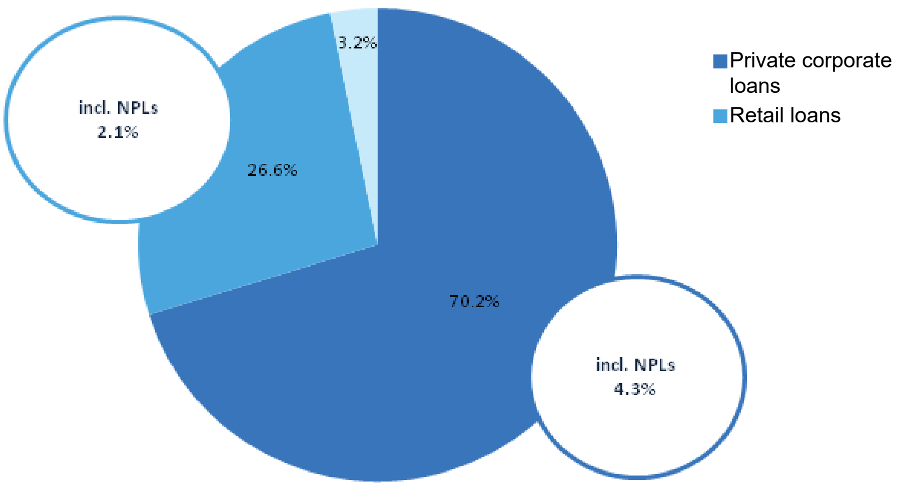
This year, loan interest rates are generally going down. Sberbank, the banking retail market maker, cut its loan and deposit rates in May without waiting for CBR to change its key interest rate.

However, with the key rate cut to 10.5 percent and the effective interest rate declining from quarter to quarter in both average and ultimate terms, almost all retail lending activities are expected to be on a downward trend throughout 2H 2016. CBR's data-based diagram depicting weighted average lending interest rates reflects the 1H 2016 market situation.



* NRA's extimates (excluding banks that do not disclose their financials publicly)

Russian banks' loan portfolio as at 1 July 2015



** NRA's extimates (excluding banks that do not disclose their financials publicly)*

According to NRA's estimates, the corporate-loans-to-total loans ratio for Russian commercial banks (excluding loans provided to government-owned entities) remained relatively unchanged in 2Q 2016 – as did the NPLs level. At 1 July 2016, the ratio was 72.5 percent (compared to 70.2 percent a year earlier). The level of corporate NPLs rose to 5.0 from 4.9 percent during 2Q 2016, while the growth during the 1q2 months ended 1 Juley2016 was more appreciable (to 5.0 from 4.3 percent).

The proportion of retail loans in the total loan portfolio decreased to 24.4 from 26.6 percent during the same 12-month period, while the level of retail NPLs rose by just 0.05 percent.

5. Corporate and Retail Deposits

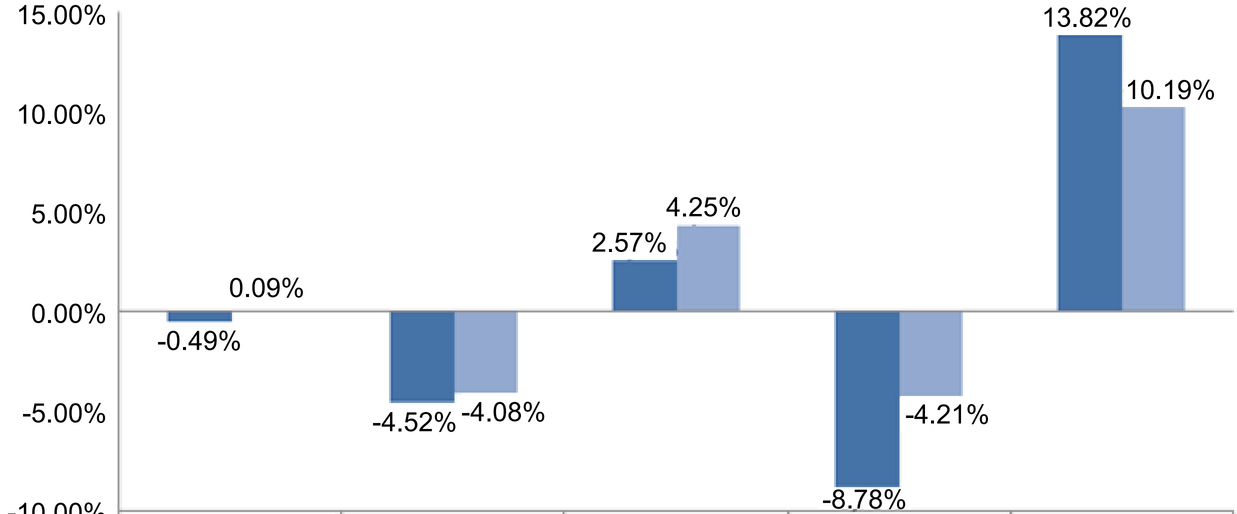
The total amount of corporate and retail deposits taken by Russian banks in 2Q 2016 (excluding banks' deposits) fell by 0.49 percent to RUB 43.5 trillion. In 1Q 2015, it increased by just 0.8 percent to RUB 43.5 trillion. The decrease was the result of two opposite trends, a 4.52 percent decline in corporate deposits and a 2.6 percent increase in retail deposits (to RUB 23.2 trillion and RUB 22.5 trillion respectively) Similar trends were observed in 2Q 2015.

"Total deposits grew 12.1 percent YoY, and the balances of current accounts of corporate entities and individuals rose by 19.6 percent and 25.4 percent respectively".

The retail deposit trend is maintained due to current account balances. Term deposit balances grew only marginally – by 1 percent – since the beginning of the year, according to CBR.

"The role of the FX component of total deposits is going down slowly, due largely to the ruble strengthening. The proportion of FX-denominated deposits in the total deposit portfolio remains high at 25.7 percent, similar to what was observed 11 months back".

Trends in Russian banks' customer deposits in 2Q2016 and 2Q 2015

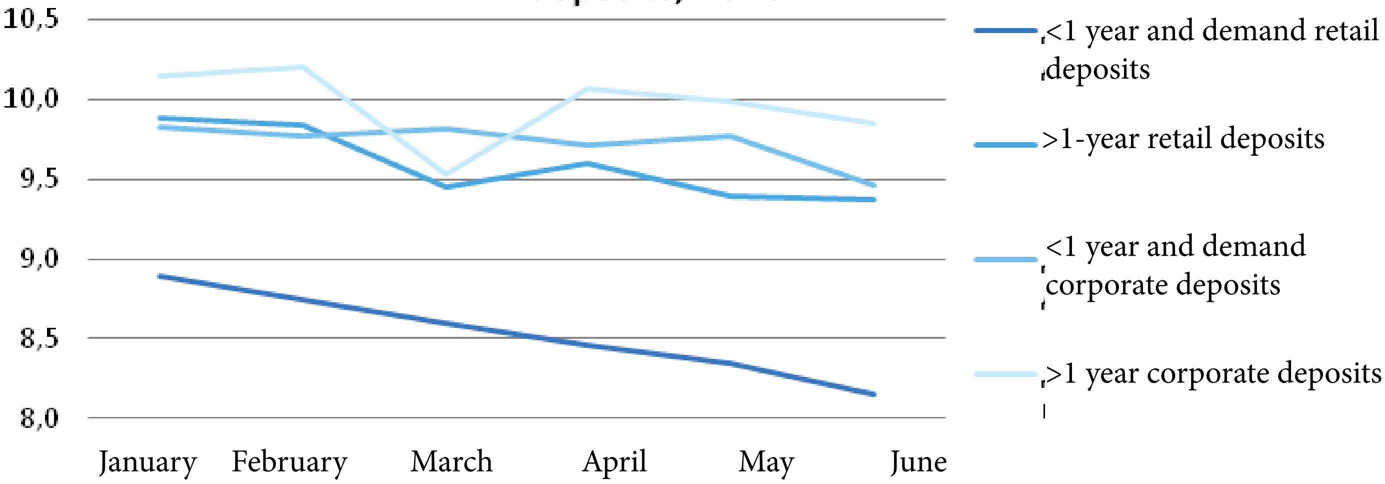


	Customer deposits	Total corp. customer deposits	Total retail deposits	Corp. accounts	Retail accounts
2Q 2016	-0.49%	-4.52%	2.57%	-8.78%	13.82%
2Q 2015	0.09%	-4.08%	4.25%	-4.21%	10.19%

*NRA's estimates (excl. banks that do not disclose their financials publicly)

Depositors' interest on bank deposit products (particularly with a term of less than 1 year) continued to decline this year. The largest banks offer rates not higher than 2 percent for dollar-denominated deposits and even less attractive rates for euro-denominated deposits.

Weighted average interest rates for ruble-denominated deposits, 2016*



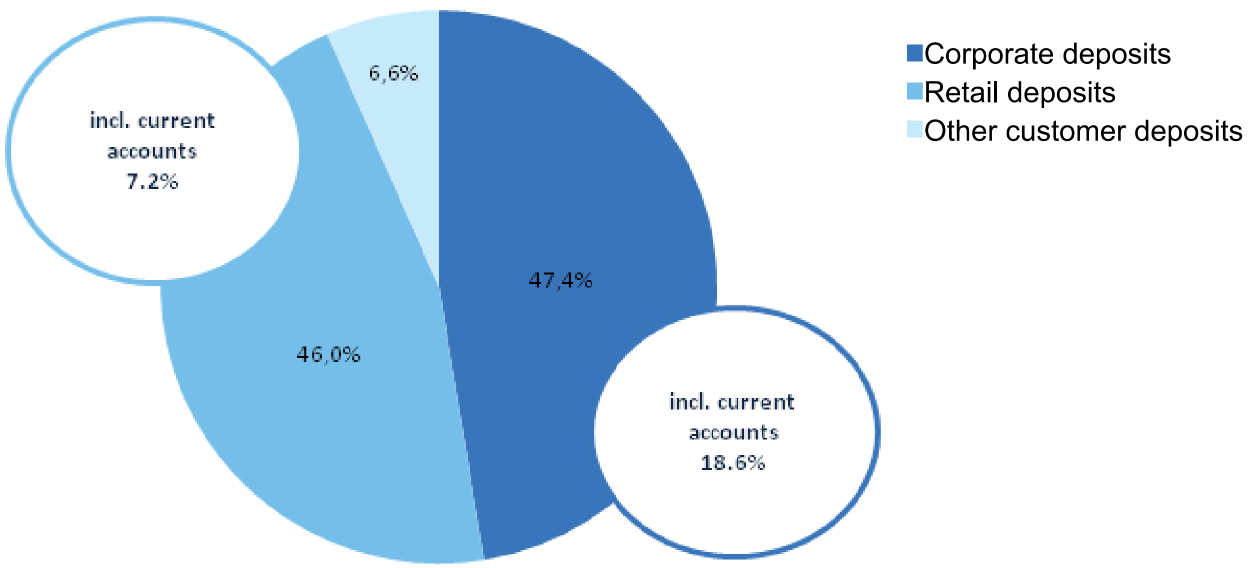
* CBR's data, excluding Sberbank'sinterest rates

"This year, bank deposit trends are influenced not only by lower deposit interest rates, but also by the falling real incomes. The downward trend is likely to continue, as the rates keep declining even with the key interest rate staying at 10.5 percent".

The share of corporate entities' deposits in total customer deposits taken by the Russian banks declined to 47.4 from 51,2 percent during the 12 months ended 1 July 2016. The share of corporate current accounts in the banks' total liabilities to corporate customers rose to 18.6 from 17.4 percent over the same period.

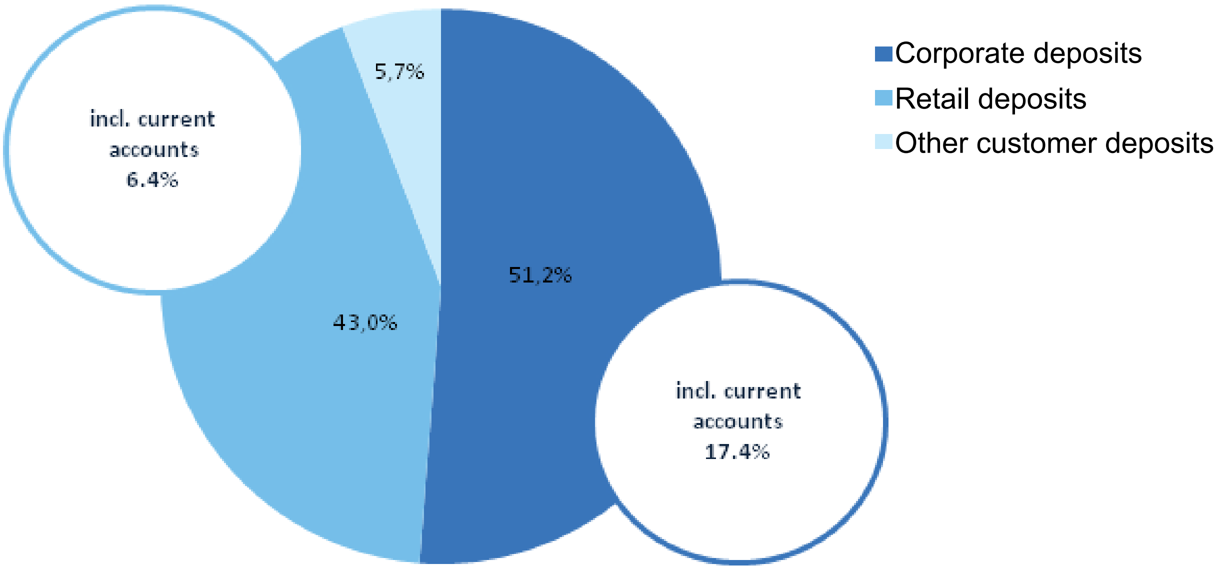
The share of retail deposits increased to 46.0 from 43.0 percent over the same period, and the share of retail current accounts in the banks' total liabilities to retail customers is now 7.2 percent vs. 6.4 percent at 1 July 2015.

Structure of Russian banks' customer deposits as at 1 July 2016



NRA's estimates (excl. banks that do not disclose their financials publicly)

Structure of Russian banks' customer deposits as at 1 July 2015

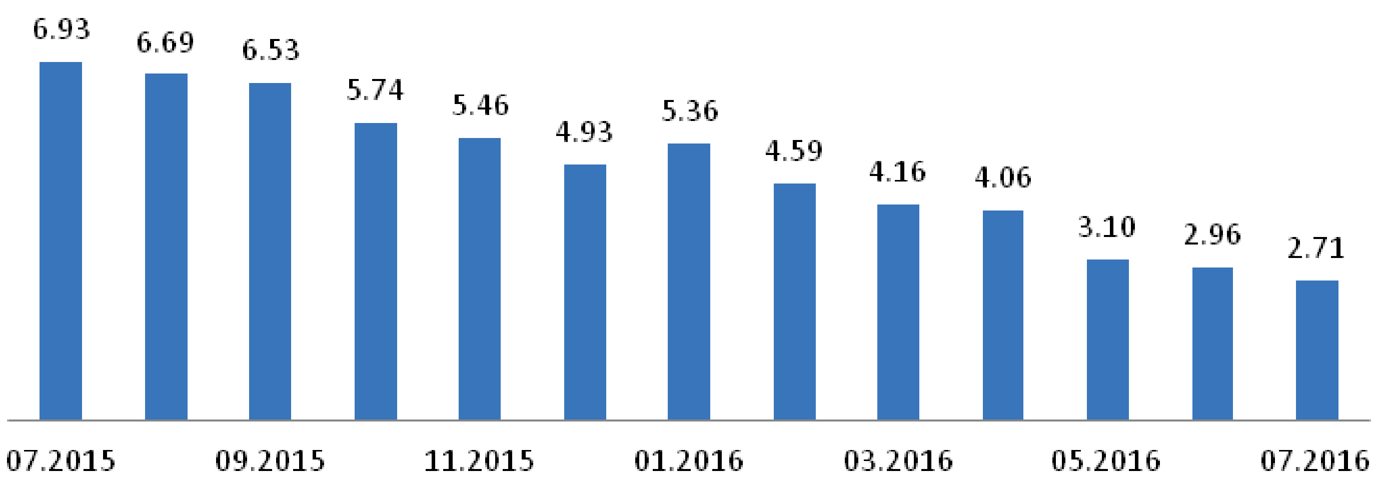


NRA's estimates (excl. banks that do not disclose their financials publicly)

6. Liquidity

The Russian banks' borrowings from CBR were reducing consistently in 2Q 2016. The total amount of loans provided by CBR fell by 1 July 2016 to RUB 2.71 trillion. At 1 July 2016, various amounts borrowed from CBR were passively held by 92 banks (compared to 124 at the end of 1Q2016), with Sberbank, VTB and Otkritie FC accounting for almost 78 percent of these funds.

CBR loans provided between 1 Jul 2015 and 1 Jul 2016, trillion rubles



CBR's data

The banking sector's liquidity experienced mixed trends during2Q 2016. Large and systemically important banks generally maintained stable liquidity metrics at the lower bound of the range (0.25 p.p.), according to NRA's *Bank Liquidity Barometer*. Medium-sized private banks often experienced liquidity shortages.

"In 2Q 2016, a number of medium-sized banks took advantage of the favourable stock market conditions in the world and in Russia, namely the rising indices, to sell their trading portfolios, which allowed them to markedly improve their current ratios".

This was one of the reasons why a reduced number of banks (22 out of 100) showed an ultimate liquidity of less than 0.25, the best result observed in 2016.

The liquid-assets-to-net-assets ratio was 22.6 percent for the market as a whole, and lower for 204 banks disclosing their financials.

The liquidity coverage market-average (median) ratios were, as usual, much higher than the regulatory minima, but 18 banks were failing to comply with one or more liquidity requirements (the N2, N3, and N4 ratios) in 2Q 2016. In the first three months of the year, there were 23 non-compliant banks, most of which were either banks under rehabilitation or banks deprived of their licenses by the time of publication of this report.

CBR notes that the Russian banks' liquidity requirements will increase by RUB 0.4-0.5 trillion due to the need to hold more funds with the central bank after the raising of the minimum reserve requirements.

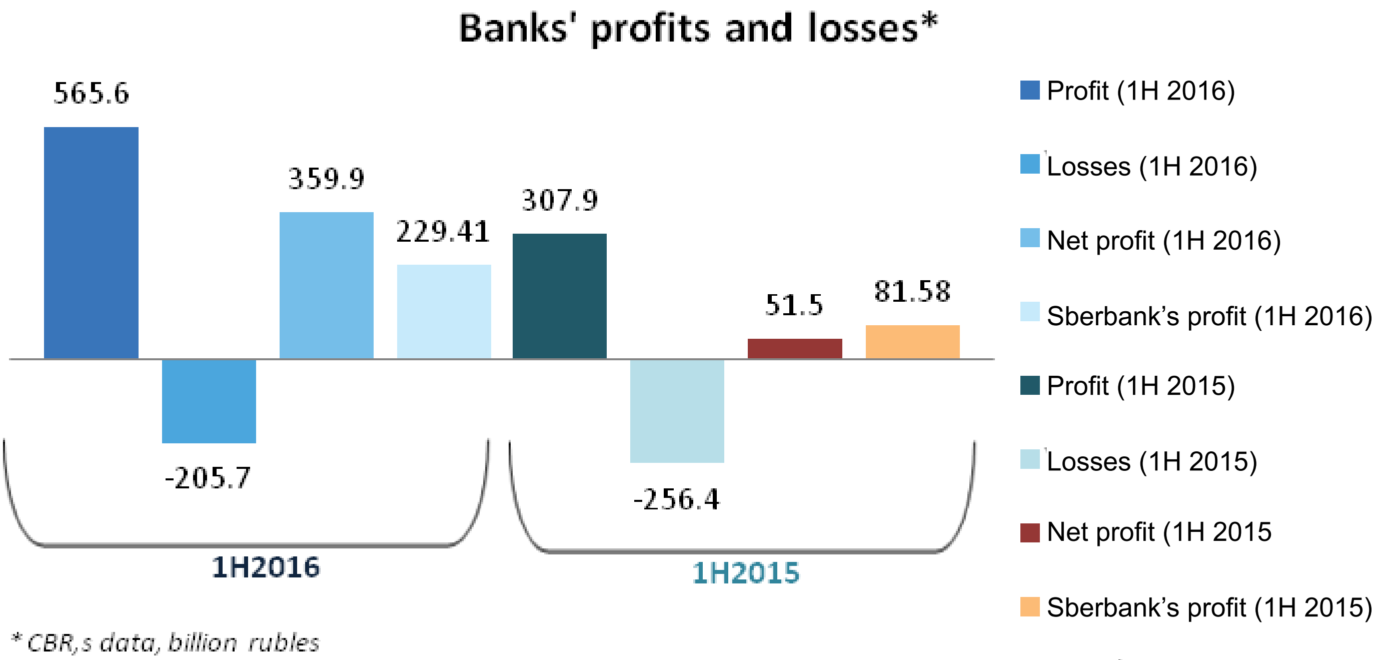
7. Profitability

The Russian banking sector's net earnings grew to RUB 51.5 bn from RUB 6 bn during 2Q 2015, driven by the profit of Sberbank that had earned RUB 81.6 over 1H 2016.

"The 1H 2016 performance was much better compared to the 1H 2015: the Russian banks' net income was RUB 359.9 bn, including RUB 229.4 bn earned by Sberbank".

loss-making ones increased to 209 from 240 during the past 12 months.

VTB posted a second-highest bottom line of RUB 39.8 bn, but this impacted the overall financial result to a much lesser extent than Sberbank's net income. The more so, BM Bank, a VTB subsidiary, posted the sector's greatest losses (minus RUB 27.4 bn for 1H 2016), even if associated with the Bank of Moscow's "unconventional" re-organization.



The biggest losses were made by Rost Bank, currently under rehabilitation, (RUB 2.5 bn) and Yugra Bank (RUB 19.3 bn). As in 1Q 2016, banks under rehabilitation, such as Baltinvestbank, Mosoblbank and Fondservisbank, were among the 20 most profitable Russian banks in 1Q 2016.

The growth of loan-loss reserves was one of the main reasons behind the decline of the banks' earnings this year, reflecting not only the regulator's reserve revaluation decision, but the persistent increase in overdue debts and NPLs as well.

"By NRA estimates, reserves kept by active banks totaled RUB 5.5 trillion at 1 June 2016, a 2 percent, or RUB 109-bn increase during 2Q 2016 (a 20.9 percent, or RUB 957.4-bn increase YoY)".

Incomes and expenses of active Russian banks, billion rubles

Indicator	1H 2016	Percentage of total, %	1H 2015	Percentage of total, %
Income, total	**118 229.5**	***100.0***	**99 122.5**	***100.0***
Income on corporate banking operations	2 089.9	*1.8*	1 972.8	*2.0*
Income on retail banking operations	874.2	*0.7*	906.3	*0.9*
Income on securities trading	672.8	*0.6*	796.5	*0.8*
Income on FX and precious metal operations	107 819.7	*91.2*	87 992.3	*88.8*
Fees and commissions	538.9	*0.5*	451.2	*0.5*
Other incomes	6 234.0	*5.3*	7 003.4	*7.1*
Expenses, total	**117 860.3**	***100.0***	**99 070.0**	***100.0***
Expenses on corporate banking operations	1 295.5	*1.1*	1 479.5	*1.5*
Expenses on retail banking operations	873.3	*0.7*	700.1	*0.7*
Expenses on securities trading	204.5	*0.2*	471.3	*0.5*
Expenses on FX and precious metal operations	107 828.4	*91.5*	87 881.2	*88.7*
Fees and commissions	133.8	*0.1*	92.3	*0.1*
Other expenses	7 524.8	*6.4*	8 445.6	*8.5*

CBR's data

As in 1Q2016, in the first six months of 016,

"Corporate lending and other corporate banking operations had been the most lucrative business lines for Russian banks. The sector's net income on corporate banking operations was RUB 794.4 bn in 1H 2016 (RUB 393.3 bn in 2Q 2016)".

That was a considerable improvement upon the last year., when net income on corporate loans was RUB 493.3 bn in the six months and RUB 244 bn in the 2nd quarter. Securities trading was the second most lucrative business line that generated RUB 468.3 bn in the six months and RUB 244 bn in the 2nd quarter, followed by net fees and commissions (RUB 405.1 bn and RUB 211.2 bn respectively).

8. Equity and Capitalization

The zero growth of equity (capital) is partly due to the reduction of the banks' N 1.0 equity adequacy ratio – to. 8 from 10 percent. Despite the NPLs increase, weighing on the sector's capitalization, most of the banks can, for the time being, get by with their current equity levels, without rising them, in the context of the general lending stagnation.

“The N1.0 median for the sector stayed at the beginning of 2nd quarter level (20.37 percent at 1 July 2016), that was higher than at the beginning of the year (19.83 percent) and higher than at1 July 2015 (19,33 percent), when the N1.0 regulatory minimum was 10 percent”.

However, the number of banks not complying with the N1.0 minimum at 1 July 2016 was greater than a year ago (14 vs. 9) as a result of a greater number of banks under rehabilitation. At the same time, there were only three banks (iMoneyBank, Bashkomsnabbank and Post Bank) with the N1.0 minimum exceeded by less than 1 percent compared with 33 banks at 1 July 2015

The sector’s capital increased at a healthy rate in the course of 12 months (by 9.76 percent to RUB 8.84 trillion), outpacing the asset growth during the same time period (6.7 percent). However, this result was due to a modest 2015 base, as the total equity of the banks (excluding those that do not disclose their financials publicly) decreased 0.8 percent.

9. Outlook for 3Q 2016 and 2016 as a whole

As was noted in the 1Q 2016 review, the 2nd half of 2016 and probably 2017 will see a continued banking sector consolidation, mainly at the expense of smaller players. The use of CBR loans by the DIA, the regulator’s plan to reform the bank rehabilitation system, and the development bail-in schemes, under which large lenders should become responsible for a bank’s rehabilitation do not go contrary with this outlook.

“Therefore, the ongoing concentration of the sector’s assets and risks in the largest institutions will continue”.

One may also expect new increases in the rate of contributions to the deposit insurance fund, especially if CBR takes over the control (currently administered through the DIA) of the rehabilitation procedure.

“The key rate is expected to go down to 10.0-9.5 percent in 2H 2016, if macroeconomic statistics live up to the CBR projections”.

(e.g., if oil prices are within S 40/barrel, inflation is at 5-6 percent p.a. and the inflationary expectations are lower).

The government expenditures have been fixed for the next three years – a risk repeatedly commented on by the CBR senior management in connection with the key rate-revision. But the regulator is apparently taking a cautious stance, as the Russian economy remains strongly dependent on external conditions, such as the oil price trends, and the real incomes keep doing down.

“The cost of deposits for banks, increased due to the rising rate of contributions to the deposit insurance fund, may markedly speed up the decline in retail deposit rates, which the banks often set without looking at the CBR key rate”.

Likewise, loan interest rates will continue to go down in 2H 2016, with effective interest rates in both average and ultimate terms expected to be lower in 4Q 2016 than in 3Q 2016 for practically all lines of retail lending. Meanwhile

“Mortgage lending will remain one of the key retail lending drivers”.

The banking sector liquidity will by and large be stable due to the biggest banks, that enjoy better access to liquidity facilities and a greater market power.

“Growing loan loss reserves will be weighing on the banks’ profitability until the year end, although the sector’s bottom-up will probably improve (to RUB 598 bn) compared with 2015”.

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